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TAX

Tax Reform and AHV Financing (TRAF): Linking Two Construction Sites

The key points of the Tax Proposal ("**TP17**") are essentially those of the rejected Corporate Tax Reform III ("**CTRIII**"). Besides the abolition of preferential tax regimes, it includes instruments to preserve the competitiveness of the Swiss tax system. As a new element it features the linking with AHV financing. For some, the TP17 is a guaranteed success, while others reject it for dogmatic reasons.

1 INTRODUCTION

The TP17 is the answer to the criticism and the failure of the CTRIII. The planned measures under the TP17 were presented in our newsletter of August 2017. These measures were largely adopted in the course of parliamentary deliberations.

The key element of the proposal is the **abolition of tax regimes** which are not internationally accepted. In Switzerland, however, these tax regimes are very important from an economic point of view. According to the Federal Tax Administration, the tax income from companies benefiting from tax regimes amounts to about one fifth of the annual revenues from corporate income tax. The CTRIII was supposed to have abolished these tax regimes by 1 January 2019. As this was not the case, the companies are therefore under pressure from foreign tax authorities and threatened with countermeasures; they would need a solution as early as next year. It is questionable whether this will be possible. Due to the discussion on instruments to preserve Switzerland's competitiveness as a business location and about how the resulting tax losses should be financed, the **implementation of TP17 is currently delayed**. Tax shortfalls arise because all companies can benefit from the measures and in particular from the planned cantonal profit tax reductions (which are not part of the proposal). Consequently, the tax burden on companies benefiting from tax regimes will rise due to the tax reform, while it will be lower for the vast majority of companies.

2 PARLIAMENTARY DELIBERATIONS

2.1 GENERAL

The Federal Council approved the TP17 on 9 June 2017. The consultation process was completed in December 2017. The final report on TP17 was published on 21 March 2018 and followed by the debate in parliament. Already in the aftermath of the introductory debate, the Commission for Economic Affairs and Taxes of the Council of States ("**EATC**"), decided upon a **compensation via the AHV** as an alternative to increasing the family allowances. The Commission was of the opinion that the proposed higher family allowances would not provide a sufficient social compensation. Based on this, TP17 has grown into TP17 with AHV financing ("**TRAF**").

> "The parliament has linked TP17 with AHV financing to create a social balance and increase acceptance of the proposal."

In the course of the parliamentary deliberations, **further key adjustments to the TP17** were decided:

> Reduction of dividend taxation at cantonal level to at least 50% (instead of 70%)

> Reintroduction of the deduction for self-financing

> Introduction of a repayment rule regarding the capital contribution principle

In the following, these new TRAF measures will be discussed. In addition, further adjustments have been made to TP17, such as an extension of the capital tax relief, which the cantons can introduce at their discretion. While the TP17 provided for such a capital tax relief only for participations, patents and similar rights, Parliament decided that it could also be granted for intra-group loans.

2.2 INCREASE OF DIVIDEND TAXATION

The Corporate Tax Reform II ("**CTRII**") introduced the **partial taxation of dividends** (effective since 1 January 2009). On **federal level**, income from qualifying participations (participations of at least 10% in the capital of a company) in private assets is only taxable to the extent of 60% and in business assets to the extent of 50%.

By contrast, the **cantons** are completely free to decide whether and to what extent they wish to reduce the economic double taxation burden. In addition, various relief methods are possible under existing law (partial taxation versus partial rate procedure). All cantons have taken respective measures.

According to TP17, it was planned to increase the partial taxation of dividends from qualifying participations in private and business assets of natural persons at federal and cantonal level to at least 70%. The cantons may also impose higher taxation. In addition, the TP17 stipulates that all cantons must apply the partial taxation method. As part of the consultation, the planned **minimum taxation at cantonal level was reduced to 50%**, as otherwise there would have been vehement opposition from commerce, SMEs and family businesses.

The majority of the cantons already levy taxation of at least 50% or even higher. Only four cantons have a tax rate of less than 50% (UR, GL, AI, AG). Based on the TRAF, only these four cantons would have to raise the partial tax rate. As a result, less additional revenue is generated to finance the TRAF.

2.3 INTRODUCTION OF DEDUCTION FOR SELF-FINANCING

The **Notional Interest Deduction** ("**NID**") was a component of CTRIII. The NID can be granted on **the above-average equity capital**. Above-average equity is the capital that the company does not need in the long term (core capital) and which could therefore be replaced by debt. The imputed interest rate is based on the yield for ten-year Federal notes. If the equity is attributable to receivables from related parties, an interest corresponding to the third-party comparison can be deducted.

The Federal Council in its proposal deliberately removed this measure. The Council of States has reintroduced the possibility of the NID for the cantons (optional), but has provided for a clear restriction. The NID can **only be applied by high-tax cantons** which have a cumulative effective corporate income tax rate (i.e. federal, cantonal and municipal) of at least 18% at their main municipality. In the future, this would probably only be the case in the **Canton of Zurich**. The deduction must also be included in the calculation of the relief restriction (maximum 70%).

According to the Canton of Zurich, not only companies that undertake financing functions for foreign groups (holding companies or Finance Branches) in Switzerland, but also SMEs can benefit from the NID.

2.4 REPAYMENT RULE FOR THE CAPITAL CONTRIBUTION PRINCIPLE

CTRII introduced the capital contribution principle ("**CCP**"), which has been in force since 1 January 2011 (see our newsletter of December 2010). **Capital contribution reserves** ("**CCR**") are contributions, share premiums and subsidies from holders of participation rights (e.g. shareholders) to a corporation or cooperative. CCR can be repaid over several years **without income tax or withholding tax consequences**. The introduction of the CCP resulted in unexpectedly high tax losses, which is why the CCP quickly came under major criticism and has long been requested to be restricted. Within the framework of CTRIII, Parliament decided not to modify the CCP. This decision has now been revised. In the overall picture, this rule must be seen in the context of the new upper limit for dividend taxation for cantons, which has been lowered from 70% to 50%.

The TRAF provides for a repayment rule in the CCP according to which repayments of CCR are only exempt from withholding and income tax if the **company distributes taxable reserves to the same extent**. However, the rule only applies to companies listed on a **Swiss stock exchange**. An extension to all listed companies was rejected. At the same time, the following **list of exceptions** was introduced, according to which the repayment rule does not apply to CCR:

> which arose within the scope of cross-border group-internal restructuring (i.e. demerger, merger, quasi-merger, asset transfer or transfer of the registered office or effective management to Switzerland) after 24 February 2008 ("**Foreign CCR**");

> which are repaid to domestic or foreign legal entities that hold at least 10% of the capital of the providing company;

> which are repaid in the event of a liquidation or the transfer of the registered office or effective place of management abroad.

The rule also includes a **partial liquidation rule** in the event of the repurchase of own shares. According to this rule, at least half of the corresponding liquidation surplus must be charged to the CCR. If this rule is not respected, the amount of the CCR is adjusted accordingly and the taxable portion of the liquidation surplus is reduced.

"The concrete implementation of the CCR repayment rule leaves a lot of questions unanswered."

The implementation of this rule raises many questions and issues. For example, it is unclear how the enforcement of the income tax consequences should be tracked in the event of a breach of the repayment rule. In addition, the affected companies will have to subdivide the existing CCR (determination of the Foreign CCR) and track its development since February 2008 (increase and repayments); this should prove difficult.

2.5 AHV FINANCING

The TP17 experienced a significant change with the EATC proposal to abolish the controversial increase in family allowances and instead link the TP17 **with financing of the AHV**. However, the basic idea remains the same: it is about "**social compensation**". The amount of additional financing of the AHV should correspond to the expected shortfall in revenue of the Confederation, cantons and municipalities as a result of the TRAF, according to the principle that each lost tax franc is financed with one AHV franc (presumably approx. CHF 2 billion annually). According to the Federal Council, this would result in the AHV falling into the red three to four years later. There is **no material connection** between the two proposals, but the lack of adequate social compensation is considered to be the reason for the failure of CTRIII, which is why it is considered - in some form or another - decisive for the acceptance of the TP17.

The AHV financing is achieved by **increasing employee and employer contribution rates** by 0.3% (0.15% each), but also by full **allocation of the demographic percentage** from value-added tax to the AHV and **increasing the federal contribution**. This means that the AHV financing is distributed between the federal government, employers and employees (one third each).

A legal expert opinion confirms that the coupling of these matters does not violate the unity of the matter, but this was nevertheless questioned in Parliament. Despite the controversial discussion, the idea of AHV financing was, surprisingly, never really at risk during the deliberations. It seems that the social compensation of the tax reform is widely recognized.

3 OVERVIEW AND TIMELINE

On 28 September 2018, the Parliament adopted the TRAF in the final vote of the autumn session. The final version of the TRAF provides for the following **measures**:

> Abolition of the regulations for special tax regimes, including separate taxation of hidden reserves (mandatory);

> Increase in the cantonal share of the revenues from direct federal tax to 21.2%;

> Adjustment of the financial equalization between the cantons and compensation of the communes by the cantons (commune clause);

> disclosure of hidden reserves at the beginning of tax liability (incl. transfer of assets, transfer of registered office or effective place of management to Switzerland);

> Increase in dividend taxation (Confederation: 70% and cantons: 50%);

> Introduction of a repayment and partial liquidation rule for the CCP;

> Extension of the transposition rule (deletion of the exception for participations below 5%);

> Extension of tax credit for permanent establishments of foreign companies;

> Introduction of cantonal tax restriction of max. 70% or less;

> Introduction of cantonal patent box according to OECD standard with maximum relief of 90%;

> Additional R&D deductions at cantonal level of max. 50% (optional);

> Deduction for self-financing in high-tax cantons (optional);

> Cantonal relief on capital tax for participations, patents and similar rights as well as intra-group loans (optional);

> AHV financing.

The TRAF is set to enter into force on **1 January 2020**. Although the tax part of the proposal appears to be generally accepted, the link with the AHV financing in particular is worth talking about. If a referendum is held, a corresponding vote would probably take place on 19 May 2019.

4 CONCLUSION AND OUTLOOK

The measure intended to save the tax reform could at the same time lead to its failure. The organization of employers and the SVP in particular are **resisting** the link between taxes and AHV. Final party positions are yet to be made, but a referendum seems likely.

The problem with the TRAF is that a **balance** must be struck between Switzerland's attractiveness as a business location and the productivity of tax revenues. The current calculations are all based on estimates that are prone to errors. The **financial impact** of TRAF can **hardly be predicted**.

Moreover, it is not easy to keep track of all the proposed measures. Accordingly, a potential referendum will presumably focus on the linking of tax and AHV matters. However, the example of the canton of Vaud has shown that a high level of social compensation increases the acceptance of the tax reform. Nevertheless, the outcome of a referendum cannot be predicted. Regardless of the tax proposal, AHV financing remains necessary. A further increase in value-added tax is also being considered as an alternative method of financing the AHV. In this respect, the linking of these two areas of business, i.e. to finance the AHV through tax revenues, seem - in one form or other - to be inevitable. However, the AHV reform as such remains necessary irrespective of the introduction of the TRAF.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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